TESTIMONY OF JAMES T. CRINES

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BEFORE THE

COMMITTEE ON WAYS AND MEANS

HEARING ON INTERNATIONAL TAX REFORM ISSUES

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Mr. Chairman, Ranking Member Levin and distinguished members of the Ways and Means Committee, I appreciate the opportunity to present the views of Zimmer Holdings, Inc. ("Zimmer") on the need for reform of our nation's international tax laws.

My name is Jim Crines. I am the Chief Financial Officer of Zimmer, a global leader in the design, development, manufacture and marketing of orthopaedic reconstructive devices, spinal and trauma devices, dental implants and related surgical products. Our history dates to 1927, when Zimmer Manufacturing Company was founded in Warsaw, Indiana, which remains the location of our world headquarters. For 2010, Zimmer reported global net revenues of over $4 billion and employed approximately 8,000 people worldwide. More than half of Zimmer's revenues and workforce are attributed to the United States.

Zimmer is a member of the Medical Device Competitiveness Coalition, which consists of seven U.S.-based medical device manufacturers that have been working together the last 18 months on the very topic of this hearing: How should Congress modernize and improve the U.S. international tax rules so that U.S. multi-national firms are no longer placed at a competitive disadvantage to their foreign counterparts. Zimmer, as part of the Medical Device Competitiveness Coalition, supports international tax reform that transitions the U.S. international tax system from a 'worldwide' towards a 'territorial' system. Such a system would permit companies to deploy funds for business-driven purposes without overly burdensome tax penalties, making the United States a more competitive home country for U.S.-based medical device companies, leading to increased investment in U.S. based operations.

In this testimony, I will provide a brief overview of the medical device industry, discuss how corporate tax rates factor into investment decisions, and will make the following recommendations that, if adopted, would make U.S.-based companies like Zimmer more competitive globally and would make the United States a more attractive place for investment: (1) The United States should move from its current worldwide tax system towards a territorial tax system; (2) Until a territorial tax system is established, the United States should maintain its current deferral system, which allows U.S.-based companies to defer paying U.S. tax on foreign earnings until these earnings are repatriated to the United

States; and (3) Additional tax-related incentives should be established, such as permanent expansion of the R&D tax credit, domestic retention of intellectual property developed in the United States, and lower corporate tax rates.

The U.S. Medical Device Industry

U.S. medical device manufacturers lead the world in the design and development of innovative devices that save and improve the lives of patients around the world. Zimmer is committed to U.S.-based research and manufacturing. In 2010 we spent approximately 75 percent of our 220 million research and development dollars here in the United States. Moreover, the large majority of our global manufacturing operations are based here in the United States. In addition to Indiana, Zimmer has operations in Ohio, California, Minnesota, New Jersey, and Texas.

While the United States is currently the world leader in medical device innovation and manufacturing, the U.S.-based medical device industry faces both immediate and longer-term challenges from foreign competitors. As this Committee is well aware, many foreign countries offer significant incentives to attract foreign direct investment in research and development as well as manufacturing. Additionally, most of our foreign competitors are headquartered in countries which offer corporate tax systems that provide those companies with a competitive advantage. These countries have lower corporate statutory tax rates than the United States, as well as more favorable rules for taxing the international income of their headquartered companies. In almost all cases, these foreign tax systems employ a territorial approach to the taxation of foreign earnings, as opposed to our worldwide system for taxing international profits.

Of particular concern to Zimmer, this tax imbalance has been exacerbated by the recent enactment of the 2.3% medical device excise tax contained in last year's health care reform law. When this new tax becomes effective in 2013, it will significantly raise the cost of doing business for Zimmer in the United States. If we include the impending excise tax with the corporate income tax, our U.S. effective tax rate would be nearly three times our foreign effective tax rate of 15 percent. Already, we have been forced to restructure our U.S. operations to position Zimmer to allow us to offset this impending cost. The restructuring measures have forced us to eliminate less profitable product lines and restrict growth-oriented investment, often leading to loss of both current and future employment opportunities. Other medical device companies have recently announced similar restructuring initiatives.

U.S. International Tax Laws a Key Factor in Zimmer's Ability to Be Globally Competitive

As Chairman Camp pointed out in announcing this hearing, today's global economy bears little resemblance to the global economy of 1961, when the framework of our nation's international tax laws was enacted. In 1961, Zimmer was primarily focused on the U.S. market; today, by contrast, we sell products in over 100 countries. More than 42 percent of our revenues come from overseas markets, up from less than 33 percent in 2001, helping Zimmer's revenues grow from $1 billion in 2001 to over $4 billion in 2010. Approximately 70 percent of our overseas revenue is generated from products manufactured in the U.S. and Puerto Rico. Many of our U.S.-based research and development and manufacturing jobs are dependent on our continuing success in foreign markets, with U.S.-based jobs growing about 80 percent from 2001 to 2010. In today's world, few U.S. companies that seek to manufacture and sell cutting edge technological products can survive, let alone prosper, by failing to compete effectively in overseas markets.

The global nature of our business and the highly specialized nature of our products make it vitally important that we also locate certain business operations outside the United States – product exportation alone is not feasible. Companies like Zimmer must continue to innovate in order to improve patient care and meet the unique needs of local markets. That requires that we operate close to our customers, both within and outside the United States.

Zimmer believes that the tax laws of the United States should not penalize American companies for operating in global markets. Rather, these laws should be designed to support the global growth and competitiveness of American companies, and encourage those companies to re-invest their foreign profits in the United States without additional taxation. Zimmer's foreign headquartered competitors do not operate under tax systems that impose such steep barriers to the repatriation of foreign earnings. Moreover, our foreign competitors are headquartered in countries that offer significantly lower corporate tax rates than the United States federal rate (35%) and combined federal/state rate (38%-40%).

Zimmer Supports the Movement Towards a Territorial Tax System

As part of the Medical Device Competitiveness Coalition, Zimmer has examined numerous options for modernizing the U.S. international tax system in a manner that takes into consideration the specific issues relevant to U.S.-based medical device companies that serve global markets. Some preliminary observations from this analysis are set forth below.

We would recommend the adoption of international tax laws that move the U.S. tax system towards a territorial tax regime – consistent with the approach utilized by the overwhelming majority of our major trading partners – by generally exempting from U.S. tax dividends from our foreign subsidiaries, or controlled foreign corporations (CFCs). A dividend-exemption approach would enable U.S. corporations to address capital needs in one jurisdiction (including the United States), by tapping excess liquidity in other jurisdictions without imposing a U.S. tax penalty. This would eliminate the so-called "lock out effect" inherent in the existing U.S. system that often makes it too costly to repatriate earnings to the United States. A territorial system would enable companies to deploy funds in an economically rational manner without overly burdensome tax penalties, making the United States a more competitive home country for medical device companies, in turn, leading to increased investment in productive U.S.-based operations.

We realize that the development of a territorial tax system in the United States raises numerous design issues. Policy makers need to balance the desire to modernize, rationalize, and simplify our current system while establishing safeguards to prevent erosion of the U.S. tax base. Some argue, for example, that a system that exempts foreign dividends from U.S. tax must include complicated expense allocation rules to ensure that certain U.S. expenses, incurred to benefit the global organization, are allocated to the "exempt" foreign earnings and, thus, are not deducted in the U.S. Many countries have examined such an approach and found it wanting, in part because the rules are far too complicated to implement and administer, and also because they will result in some home country expenses not being deductible in any jurisdiction. Inevitably, such tax complexity results in significant government resources expended on tax administration and litigation. In order to avoid these problems, some countries have adopted an alternative approach that, among other things, imposes home country tax on a small portion of a company's foreign earnings as a proxy for detailed expense allocation rules. We would agree that a proxy U.S. tax on a percentage of foreign earnings is preferable to complicated and likely inexact expense allocation rules.

Importance of Deferral in a Worldwide Tax System

Zimmer and other U.S. medical device makers have managed to succeed in international markets and overcome the inherent economic costs and structural disadvantages of the U.S. corporate tax system in large measure because our rules allow us to defer paying U.S. tax on our foreign earnings until they are repatriated to the United States. This "deferral" system, a long-standing feature of our tax code, somewhat levels the tax playing field from a capital deployment standpoint. However, it produces a perverse cash-management structure because our 50-year-old tax system was designed to accommodate a way of doing business that no longer exists. We believe the current U.S. tax system (combining both a "worldwide" and "deferral" system) encourages U.S.-based multinational companies to implement highly-complex tax structures and adopt restrictive capital deployment strategies that often place significant debt within the United States, while maintaining significant levels of cash within their CFCs. Certainly such tax and treasury structures do not serve the long-term economic interests of the United States.

At Zimmer, we particularly appreciate why "deferral" is so important because it was among the critical factors that enabled us to be the winning bidder in the acquisition of a foreign-based competitor. In 2003, Zimmer prevailed in a competitive bid against a U.K.-based competitor for a leading European joint replacement manufacturer, Centerpulse AG. Absent Zimmer's ability to use the deferral mechanism within the U.S. worldwide tax system, that transaction would likely not have occurred since Zimmer's *after-tax* return on capital invested would have been significantly impaired by the immediate burden of added U.S. taxes. Our U.K.-based competitor would have been positioned to provide the best offer and thus obtain control of Centerpulse. By winning the bid, Zimmer significantly expanded its overseas operations, and from 2003 to 2010 grew U.S. research and development jobs by more than 50 percent, and grew U.S. manufacturing jobs by 36 percent. It is highly unlikely that this U.S. expansion would have occurred had Centerpulse been acquired by a U.K.-based company.

Ensuring Continued U.S. Innovation

Another important issue that must be considered in the context of moving to a more territorial tax system is the treatment of royalties relating to products that are created through U.S.-based research. One option is to develop an innovation-incentive regime (often referred to as a "patent box regime") to provide a reduced U.S. corporate tax rate for certain royalties earned by the U.S. company. A number of countries in Europe have begun to implement such regimes in addition to having lower corporate tax rates within their territorial systems, but many are relatively new and deserve further study. These types of rules could create a meaningful "carrot" approach for U.S. companies to retain high-paying and important research and development jobs in the United States. Of course, another proposal, which Zimmer supports, is strengthening and permanently extending the research tax credit.

Conclusion

On behalf of Zimmer, I would like to thank the Ways and Means Committee for the opportunity to provide our views on proposals to modernize this country's international tax rules. By beginning a comprehensive examination of our nation's international tax laws and the impact they have on our global competitiveness, your Committee is undertaking a difficult, controversial, but fundamentally important task. We look forward to working with the Committee and other tax policy makers as this effort moves forward.